The Case for Dividend Investing: Enhancing Returns, Mitigating Risk

Description

My fellow Fool Robert Baillieul's article "Why Smart Investors Hate Dividends" got me thinking about the advantages of investing in dividend stocks.

The key tenet of Robert's argument is that dividends are a leakage of capital that is better utilized if it is retained by the company. This retained capital can then be used to make further investment in its business — hopefully enhancing growth and rewarding investors with an overall higher total return.

There is merit to this argument, but I am a huge fan of dividend-paying stocks — even more so now, at a time when traditional yield-paying financial instruments are effectively dead. Let me explain why.

Dividend stock yields > yields from traditional investments
At its core, investing in the stock market means that investors must accept the risk of losing money in exchange for generating a return. One way for investors to improve their return and reduce this risk is by investing in stocks that pay a consistently growing dividend.

Compared with traditional investments, dividend stocks currently deliver superior yield, as evidenced by the average dividend yield of the S&P/TSX Composite Index with that of the 10-year Canadian government bond. The index's dividend yield is around 3.2%, compared to the 2.6% currently offered by 10-year government bonds.

But the advantages don't stop there. Dividend stocks also give investors greater opportunities for capital growth than government bonds. Especially in a low interest rate environment like we have now!

Stocks appreciate in value as the issuing company's business grows in value, whereas bonds appreciate in value as interest rates fall — and with interest rates close to historical lows, it is unlikely they will fall any further.

Dividend stocks also allow investors to generate additional yield and capital growth through the magic of compounding: by simply reinvesting the dividends received.

Canada's Big Five banks all offer dividend yields higher than bond yields. The standout performer is **Bank of Montreal**

(TSX:BMO, NYSE:BMO). It has a 4% dividend yield and has maintained its dividend payment even through the fallout from the financial crisis, when most banks slashed dividends. Even better: Bank of Montreal's relatively low payout ratio of under 50% indicates that the dividend is sustainable.

Dividends are a significant portion of total market returns
Another reason to invest in dividend stocks is because dividends make up a significant portion of the stock market's overall return. Recent research by Standard & Poor's shows that since 1956, dividends have made up around 38% of the total returns generated by the S&P/TSX Composite Index.

As such, dividends are an important part of any investment portfolio's overall return. Investors should ignore dividend stocks at their peril because by excluding them they may reduce their overall returns.

Dividends reduce investment risk
By investing in dividend-paying stocks, investors can reduce risk. Primarily because dividend-paying companies have a track record of consistently generating solid revenue, earnings and cash flows.

Typically this is because they are engaged in relatively stable and predictable businesses, making them more resilient to softer economic conditions. In the event that the broader market turns south, these sorts of businesses generally have some downside protection.

Dividends also reduce investment risk because they form an additional source of tangible returns for investors. They continue to reward investors even if a company's stock price tanks due to macro events beyond its control.

In the case of income investors this reduces the need to crystallize losses from selling stocks to generate income. Whereas should the company go 'belly up' investors will have received some return on their investment.

Foolish final thoughts
Dividends are an important means of enhancing returns and reducing risk for investors. Not only do they provide a handy income stream for income-hungry investors, they deliver a superior yield to fixed-income investments.

These are not the only benefits of investing in dividend-paying stocks — in subsequent articles, I plan on reviewing some of the other advantages in more depth.

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